The role of investment incentives in attracting FDI inflows in Moldova

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EU SUPPORT TO MEPO/MIDA PROJECT

THE ROLE OF INVESTMENT INCENTIVES IN ATTRACTING FDI INFLOWS IN MOLDOVA

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DISCLAIMER

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EXECUTIVE SUMMARY

The study on incentives in relation to investment in Moldova was undertaken within the framework and overall goals of the EU Support to MIEPO project. The study was carried out through:

- a review of the research carried out in other countries in the world on incentives and their impact on foreign direct investment (FDI) inflows
- a comparison of the business climate and incentives available in Moldova with those in the neighbouring countries of Romania and Ukraine
- interviews with investors and others in Moldova, to draw upon their experience in the country.

The research material available from respected sources such as the Foreign Investment Advisory Service of the World Bank, and from other researchers, is considerable. A selection of the relevant research was reviewed with a specific focus on the economics of investment incentives in Central and Eastern Europe. General conclusions from the research were:

- Tax incentives tend to become important when all other factors are equal (macroeconomic, political, economic, social factors);
- Tax incentives do not make up for other deficiencies in the investment climate;
- Tax incentives generally neither affect significantly the amount of FDI that takes place nor usually determine the location to which investment is drawn.
- The evidence that the development of human capital can help to attract investment is compelling
- Money spent on investment promotion generally gives a good return on investment.

The comparative review of the investment climate in Romania, Ukraine, and Moldova demonstrates that there exist significant differences between these countries in terms of political, economic, market and infrastructure factors. On most of the comparative indices Moldova comes third, being positioned somewhere close to Ukraine, but quite behind Romania. Major differentiators are: corruption, investment and financial freedom, country financial risk, infrastructure, higher education and research, innovation & technology.

As regards the investment incentives mechanisms, the analysis revealed that investment incentives instruments in the region are comparable. If benchmarked against Romania, three critical incentives, which could be followed, stood out, namely i) accelerated depreciation, ii) deductions of promotional costs, and iii) various incentives to support SMEs (Small & Medium Enterprises) and foster entrepreneurship.

The incentive mechanisms in Moldova, implicitly, are geared towards supporting MNEs (Multinational Enterprises) rather than SMEs, and attracting market-seeking FDIs, rather than for example attracting efficiency-seeking FDIs.

Given the above differences in fundamentals between the three countries, and the similarities in investment incentives mechanisms, one might expect the existing tax and other financial investment incentives in Moldova may not have a significant impact on FDI inflows and thus on the growth of the economy.

In-depth interviews were conducted with foreign investors in Moldova and their representatives with the aim to hear their views and opinions in relation to their experience and any future changes that might be proposed in order to enhance the investment climate in Moldova. A total of 15 interviews were conducted.

It was significant that not one interviewee suggested that financial incentives for investment should be increased in order to enable Moldova to attract and secure more FDI, which would appear to confirm the view that emerges from other sources that companies do not consider such incentives as being particularly important.

That is, companies are more influenced by the general investment climate and factors such as political and economic stability than by financial incentives. Three generic policy areas were identified by the respondents that require immediate attention from the Government. These are: i) ease of doing business, ii) higher education, iii) infrastructure, and iv) fostering entrepreneurship.

Overall, the evidence from the extant research, the comparative analysis of the countries in the region, and the interviews underscores the fact that the single most important *investment incentive* for investors is the overall investment climate and thus a continuation and acceleration of the efforts to improve the investment climate should be a major focus for Moldova.

The main engines of economic growth are SMEs. Against the background of the small domestic market in Moldova it would seem logical to focus efforts on the development of SMEs in the country, including a focus on attracting investment from foreign SMEs.

The financial incentives currently available in Moldova do not have a particular orientation towards SMEs. But facilitation support, infrastructure, premises and a better investment climate, especially in relation to inspections and bureaucracy, could be more important as an incentive than financial incentives for this group of potential investors. The experiences of Romania in their efforts to develop the SME sector could be particularly valuable to Moldova.

The evidence from the research suggests that the *quality and availability of local skills* is growing in importance as means to attract investment and help local companies to absorb new technologies. As the knowledge based economies continue to grow in importance, so the need for increased and better human capital will grow in parallel. If Moldova is seeking investment from these economies, then investment in the education system to provide the skills required is needed.

Although the improvement of the investment climate is important for Moldova in its efforts to secure increased FDI, it is on its own not sufficient; an effective delivery mechanism is also needed to deliver results. Against this background, the efforts of the Support to MIEPO Project to develop MIEPO into a professional and sustainable institution capable of achieving results in the form of actual investments into Moldova are judged to be critical for the future economic development of the country.

A word of caution should be expressed though on the role of an Investment Promotion Agency in attracting FDI inflows. The research suggests that countries with a relatively poor investment climate or low income per capita should focus on improving these factors rather than spending on promotion. Hence, the cost-benefit analysis of a promotion campaigns is warranted.

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1.1 Setting the scene

The European Union's TACIS Programme for Moldova, Support to MEPO/MIDA, has the overall objective of promoting Moldovan exports abroad and contributing to the attraction of Foreign Direct Investment (FDI) to Moldova, through a programme of export promotion, investment promotion and business upgrading, that will strengthen Moldovan Investment Export Promotion Organisation (MIEPO) and the wider business community.

The specific objective of the project is to establish MIEPO as the key and sustainable institutional resource in Moldova for promoting Moldovan exports abroad and for managing the attraction of foreign investment into Moldova.

The Inception Report of the project includes a reference to incentives for investment. It states that the current investment incentives in Moldova, such as tax benefits will be reviewed and compared with those offered by neighbouring countries. It states that proposals will be prepared on changes and recommendations will be made to government.

The present report thus explores the role the investment incentives play in attracting and securing FDI inflows at international, regional, and country levels.

1.2 Objectives

To achieve the above, the following objectives have been considered:

- to review the current research on the impact of investment incentives on investment inflows in other countries throughout the world
- to compare the investment incentives mechanisms in the region, by comparing the investment climate in Romania and Ukraine
- to explore in depth the investment climate in Moldova
- to provide recommendations for further betterment of the investment climate in Moldova

1.3 Methodology

To achieve the above-stated objectives, desk research and collection of primary data were conducted.

To address the first two objectives, the authors reviewed the current research and other published material that is available on the subject of incentives for investment and their impact on investment inflows in other countries throughout the world, and in the region. With regard to the latter, the authors compared the incentives for investment that are currently available in Moldova with those available in the two neighbouring countries of Ukraine and Romania.

To explore the investment climate in Moldova, the authors carried out a series of in-depth interviews with various key stakeholders: local investors and their representatives, leading international and local law firms, accounting firms, donor and diplomatic community, entrepreneurs, and governmental officials.

The interview guide included three generic open-ended questions the content of which was being lightly modified depending on the respondent's nature of the business. These questions were:

- What is your experience today as an investor?
- What are your views on the investment climate in Moldova?
- What could be done to improve the situation?

The authors approached this task with an open mind with regard to the scope of the investment incentives mechanisms. That is, the authors consider it is pivotal in this kind of endeavour to reflect not only on financial incentives, but on non-financial incentives as well.

1.4 Report outline

Following this introduction, chapter 2 will provide background information on FDI and investment incentives in general and on FDI inflows into Moldova in particular. The review of extant research on the relationships between investment incentives and FDI inflows will follow next in chapter 3. Immediately after, chapter 4 will provide a comprehensive comparative analysis of the investment climate at the regional level by looking at Romania, Ukraine and Moldova. The results of the primary research will be presented in chapter 5. Chapter 6 will conclude the report by putting forward a series of policy recommendations.

2 BACKGROUND

2.1 Foreign investment

Investments into national economies are needed to increase the level of gross fixed investment and capital formation, in order to facilitate growth in the country's production and export sectors. It is from such investments that economic growth and diversification as well as high levels of employment creation and increased income can be realised.

Employment enables the productive and intellectual capacities of citizens to be used to create wealth and thus contribute towards poverty alleviation and a general increase in prosperity. Investments from both domestic and foreign sources are normally sought by national governments for this purpose.

On the expectations that foreign companies will raise employment, exports, or tax revenue, or that some of the knowledge brought by the foreign companies may spill over the host country's domestic firms, governments across the world have lowered various entry barriers and opened up new sectors to foreign investment (Blomstrom and Kokko, 2003).

In the Investment Attraction and Export Promotion Strategy 2006 – 2015 (The Strategy) of the Government of the Republic of Moldova (GoM) (www.mec.gov.md), a reference is made to the increase in foreign direct investment into the country over the last five years, but it notes that the ratio of this foreign investment within the overall total is not satisfactory. It adds:

> *"Taking into consideration the limited potential of other sources, the attraction of foreign investment should become a priority direction for the Government".*

The Strategy calls for foreign investment to be attracted and secured that will introduce new technologies, bring know-how, efficient management techniques and that will help to develop new markets for Moldovan exports.

2.2 Incentives

Incentives have traditionally been used by national governments as instruments to encourage both domestic and foreign investment. They have often been linked to national and regional economic and industrial development strategies with variations for investment into specific economic sectors and into economically disadvantaged regions. Special incentives are used by some governments to secure specific one-off very large investments, typically car assembly plants that are judged to be particularly attractive.

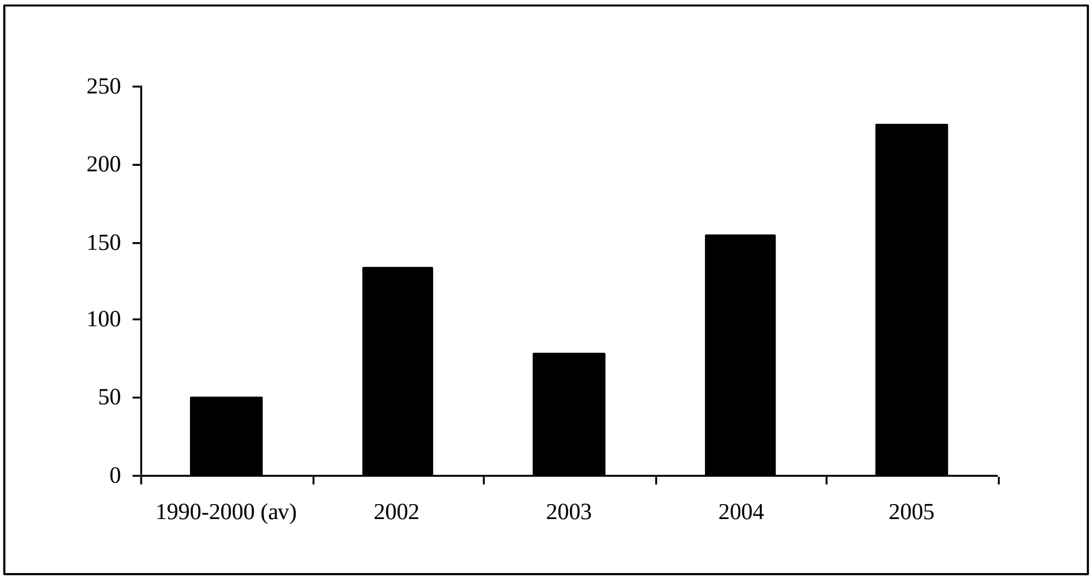
Incentives may include both financial and non-financial instruments. Examples of the former include direct grants related to capital investment, cheap loans, subsidies towards interest rates payable on commercially raised loans, equity funding, lower taxation rates and accelerated write offs for investments. Examples of the later include support for skills training, the provision of land and premises and lifestyle supports (culture, food, religion).

The Strategy refers to the introduction of fiscal incentives by the Government of Moldova with the objective of encouraging the inflow of foreign investment and the importation of modern technologies and equipment for production and services activities.

2.3 FDI inflows

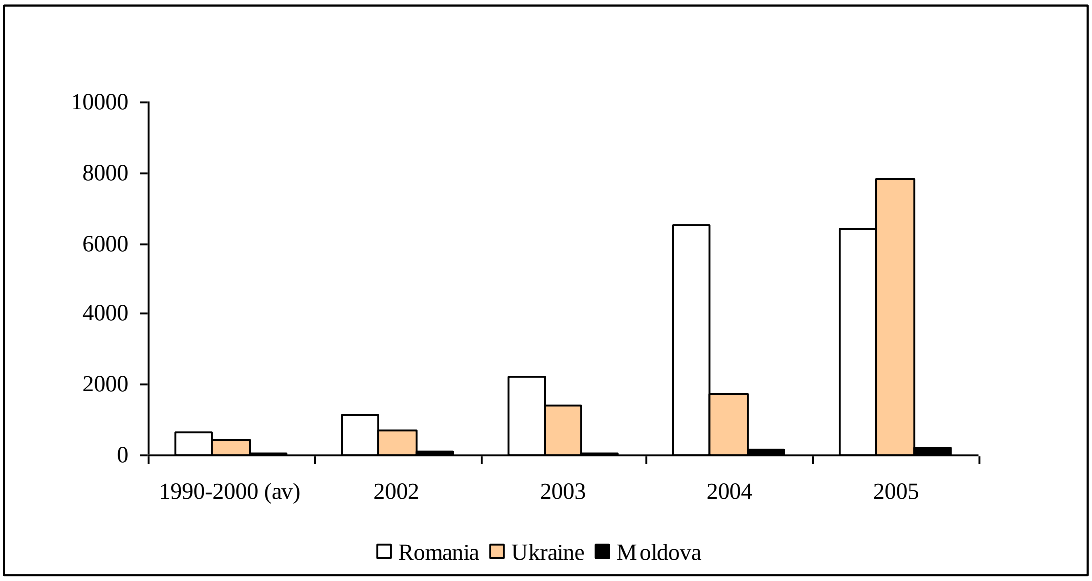
The average of FDI inflows into Moldova over the three-year period 2003 to 2005 was 152 m USD (Figure 1). As compared to FDI inflows into Romania and Ukraine (see Figure 2), Moldova comes third with a tiny percent of FDI inflows.

Figure 1. FDI inflows into Moldova, mUSD



Source: www.unctad.org and www.fdi.net statistics

Figure 2. FDI inflows in the region, mUSD

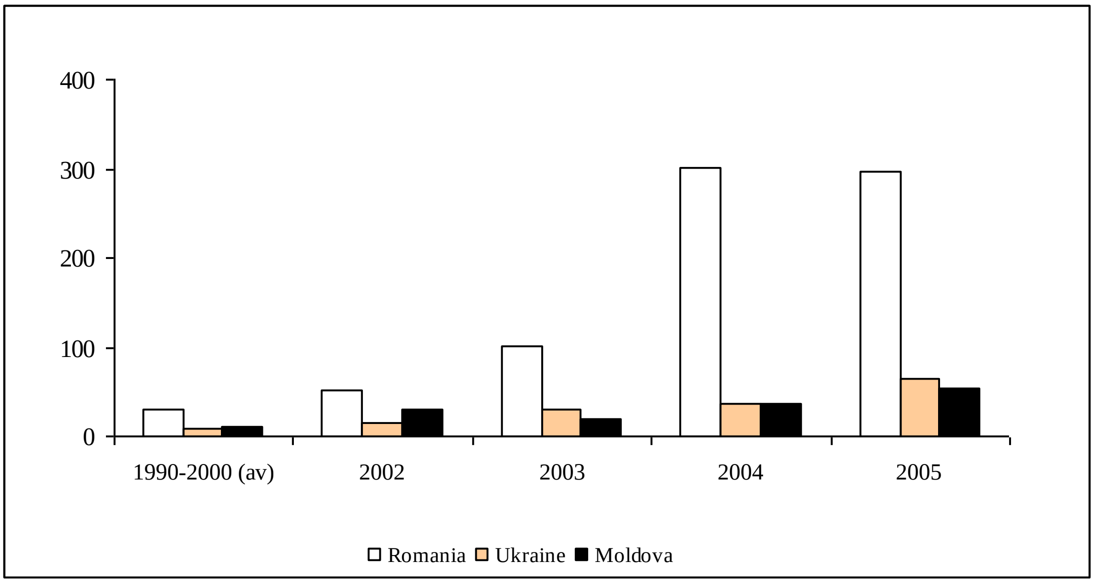


Source: www.unctad.org and www.fdi.net statistics

However, FDI statistics are often distorted by individual investments, typically in the oil industry, or acquisitions made commercially or through privatisation programmes. For example, the statistics for Ukraine show an upward surge for 2005, which is almost certainly attributable to the privatisation of the Kryvorozstali complex for a reported 4,800 mUSD.

Hence, if FDI inflows in the region are reported to the number of the population in respective countries, and FDI inflow in Ukraine is adjusted for the abovementioned privatisation, then FDI inflow per capita in Ukraine and Moldova is quite close (Figure 3).

Figure 3. FDI inflows in the region per capita, mUSD



Source: www.unctad.org and www.fdi.net statistics

2.4 Conclusion

Overall the statistics present a rather unfavourable picture of Moldova in relation to FDI inflows (as compared to Romania). This can be expressed more positively as there being enormous scope to improve Moldova's performance in the attraction of FDI.

3 REVIEW OF REARCH PAPERS ON INVESTMENT INCENTIVES

3.1 Introduction

There has been a great deal of research carried out into the role incentives can play in attracting and securing foreign direct investment, much of it under the auspices of donors such as the World Bank (the Foreign Investment Advisory Service, www.fias.net) and OECD.[1] A selection of the relevant research[2] has been reviewed with a view to identifying conclusions that may be applicable and provide some guidance to Moldova.

3.2 Incentives as FDI determinants

Table 1 below presents several findings from the review of the extant literature on FDI determinants, including tax incentives. Overall, two generic conclusions could be drawn from those findings. One is that foreign investors do not look upon financial incentives as a major reason for undertaking FDI projects. That is, tax incentives neither affect significantly the amount of FDI that takes place nor determine its location.

Two is that tax incentives play a greater part in attracting FDIs within a region if there are no major differences between the countries in the region in terms of their fundamentals and institutional context (Blomstrom and Kokko, 2003). That is, when the other country factors are equal, only then tax incentives could tip the balance.

Recent report by UNCTAD (2006) showed that financial incentives received an average rating of 3.6 out of 5 and competition and FDI policies 3.9 points. Similar findings emerged in the research conducted in Bulgaria (Bitzenis, 2003), Hungary (Sass, 2003) and Indonesia (Wells *et al.*, 2001). For example, Wells *et al.* (2001) found little evidence of any decline in FDI when Indonesia eliminated tax incentives.

Two key issues contributed to the emergence of the above findings. One, it relates to priorities foreign investors give to FDI determinants when they consider investing in one country or another. Within a region, foreign investors take into account first the institutional background and characteristics of potential host countries, and only then availability of financial incentives.

For example, according to UNCTAD (2006), the following non-financial incentives are considered by investors as being critical:

- macroeconomic stability
- stable and transparent legal framework
- lack of corruption
- quality of bureaucracy
- prospects of a country to participate to the EU
- prospects for market growth
- market characteristics
- relative production costs
- availability of production factors

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[1] It must however be stressed that an exhaustive examination of the sometimes complex issues surrounding incentives in relation to investment inflows, as reflected in the wide range of research that has been carried out, is clearly beyond the scope, and outside the time constraints, of this study.

[2] Only empirical papers were reviewed that looked into the role of investment incentives in transition economies, primarily from Central and Eastern Europe.

Table 1. Role of investment incentives

Author(s)	Year	Findings
UNCTAD	2006	…tax incentives consistently rank below core FDI determinants.
Palmade & Anayiatos	2004	[Data] points out to the need for a functioning land market and good microeconomic conditions [to enhance FDI inflows].
Morisset & Andrews-Johnson	2003	…a dollar spent on investment promotion yields a better return than a dollar provided as a subsidy, or a dollar given up through a tax incentive program.
Blomstrom & Kokko	2003	The use of tax incentives to attract in FDI does not, in general, raise national welfare.
Sass	2003	…the emphasis may be shifted to financial incentives, with fiscal incentives diminishing in significance.
Bitzenis	2003	…tax incentives [in Bulgaria] seem to be of less importance for the majority of foreign investors…, and the Bulgarian government eliminated most of them.
Nunnenkamp	2002	There have been no great changes in the determinants of FDI in developing countries for the past 20 years, with the exception of skill availability.
Gorg	2002	…incentives need to be matched by improvements in hiring and firing costs.
Wells et al.	2001	…tax incentives will generally neither make up for serious deficiencies in the investment environment nor generate the desired externalities.
Wells & Wint	2000	…an efficient investment promotion program is less costly than a typical program of tax holidays.

Source: the Authors

Two, it is the question about the cost-effectiveness of the tax incentives mechanisms (Bitzenis, 2003; Blomstrom and Kokko, 2003; World Investment Report, 2006). For example, according to the World Investment Report (2006), tax incentives can distort the allocation of resources and imply a drain on scarce public resources. It is suggested in the report that before granting any [tax] incentives, countries should seek to assess whether such incentives are warranted in terms of priority and associated costs and benefits.

One of the major concerns for a Government in this regard is how to calculate the gap between the social (potential spillovers or desired externalities)[3] and private rates of return for FDI. The national welfare will increase only if the investment incentive is smaller than the value of the externality. If subsidies (tax incentives) are larger than what is motivated by the externalities, the host country will not only lose public revenue, but the incentives will also discriminate against local firms that may lose jobs and market share (Blomstrom and Kokko, 2003.

[3] Spillover effect represents the positive effect of existing FDI on the economy via the increase in capital intensiveness, level of technology transfer, creation of clusters, market access, management know-how, increase in labour productivity and supporting services (Blomstrom and Kokko, 2003; Sass, 2003).

Linked to the above is also the issue of efficient allocation of resources. For example, research data suggests that a dollar spent on investment promotion yields a better return than a dollar provided as a subsidy, or a dollar given up through a tax incentive program (Morisset & Andrews-Johnson, 2003). On the other hand, the research suggests countries with a relatively poor investment climate or low income per capita should focus on improving these factors rather than spending on promotion (Morisset and Andrews-Johnson, 2003).

3.3 Governments' expectations

As mentioned earlier, governments expect FDIs will boost the economic growth, increase employment, ensure stability, reduce poverty, and develop and enhance the infrastructure. In the long term, FDI may influence the growth rate through its impact on two exogenous factors: technological development and change in the amount of labour employed (Sass, 2003).

In developing countries however there is often a lack of capacity to evaluate the benefits from individual investment projects and policies and this, combined with other weaknesses such as a culture of corruption, may lead to a poor result (Charlton, 2003).

To address the above issue, the extant research suggests for example that incentives should not be of an *ex ante* type that is granted prior to the investment, but they instead should promote those activities that create a potential for spillovers (Kokkinou and Psycharus, 2005).

Spillovers may include the knowledge "leaking" into the local economy through the subsidiary (organisation forms, improvement of human capital, improvement of fixed assets), as well as effects through various contacts of the subsidiary with local companies (joint ventures, technical-technological links, technology transfer, orders, sale of intermediate products, market access, improved financing conditions, more intense competition) (Blomstrom and Kokko, 2003; Sass, 2003).

The governments may achieve the above by attaching various performance requirements to the incentives to assure the FDI "delivers" the expected positive impacts. Such performance requirements may include local value added, export, employment-related, and R&D requirements as well as a requirement on domestic participation (Sass, 2003).

However, investment incentives aiming to increase the potential for spillovers may be inefficient unless they are complimented with measures to improve the local learning capability and to maintain a competitive local business environment (Blomstrom and Kokko, 2003).

Hence, for the spillovers to have an impact, the governments first of all should consider enhancing and promoting linkages between foreign and local firms. Simultaneously, they should consider subsidising local firms to strengthen their capacity to absorb foreign technology and skills.

3.4 Conclusion

This chapter provided the findings form the extant empirical research undertaken to explore the role investment incentives play to attract FDI in transition economies, primarily from Central and Eastern Europe. An opened minded approach was used in the study and the danger of being selective, in order to support particular views, has been resisted.

Overall, the main conclusions that can be drawn are that:

Tax incentives

- will generally neither make up for serious deficiencies in the investment environment nor generate the desired externalities
- neither affect significantly the amount of FDI that takes place nor usually determine the location to which investment is drawn
- may exert a significant impact, when factors such as political and economic stability, infrastructure and transport costs are more or less equal between potential locations.

Incentives instruments need to

- encourage spillover effects
- spark backward links which would contribute to the enhancement of the learning and technology absorption capability of local firms
- be aggressively promoted

The evidence from the research also suggests that the *quality and availability of local skills* is growing in importance as means to attract investment and help local companies to absorb new technologies. As the knowledge based economies continue to grow in importance, so the need for increased and better human capital will grow in parallel. If Moldova is seeking investment from these economies, then investment in the education system to provide the skills required is needed.

As a general conclusion, the authors side with Kokkinou and Psycharis (2005) who argue that incentive policies should include macroeconomic, political and social stability, economic liberalisation, competition conditions, amenable investment environment, people, improved infrastructure, strategic location, strong competition, linkage creation, and technical networks.

4 MOLDOVA IN COMPARISON WITH ROMANIA AND UKRAINE

4.1 Introduction

The previous chapter looked into the role of investment incentives in attracting FDI. Several key findings emerged from the review of the extant research on the subject. The data suggests that tax incentives generally neither make up for serious deficiencies in the investment environment nor generate the desired externalities or spillover effects.

The data also points out to the fact that tax incentives neither affect significantly the amount of FDI that takes place nor usually determine the location to which investment is drawn (Bitzenis, 2003). And finally, the empirical research demonstrates that tax incentives may exert a significant impact, when factors such as political and economic stability, infrastructure and transport costs are more or less equal between potential locations.[4]

The generic conclusion from the above findings is that the macro- and micro indicators, especially at the regional level, are playing an increasing role in swinging the investors' decisions towards one country or another. Clearly, a country may not be good enough in all of its indicators, but it is the combination of all the indicators that shapes the final decision of the investors.

This chapter thus aims at comparing the relative status of Moldova' with those of Ukraine and Romania by reference to published business and competitiveness indicators and by comparing the support and incentives available for investment in each country.[5]

The analysis that follows is based on the comparison of Moldova investment climate to the investment climate in Romania and Ukraine and builds on three major elements which impact the decisions of potential investors:

- Generic risks of business operations (political, financial, level of transparency, etc.)
- The level of microeconomic competitiveness (incl. the level of basic operational costs of doing business)
- The level of achieved fiscal, regulatory and financial incentives for attracting FDIs

Conclusions and recommendations are provided at the end of the chapter.

4.2 Traditional operational risks

When evaluating the investment opportunities, the investors firstly consider the standard risks of business operations which are in their view the first indicators of the quality of the investment climate of a country. Recent review of the FDI confidence index for 2005 (www.atkearney.com) suggests that although traditional operational risks such as government regulations, and financial, political and social instability appear to be less threatening, these traditional "macro" risks remain among the leading hazards to operations.

[4] For review see also Bevan and Estrin (2000), Khanna et al. (2005), Kokkinou and Psycharis (2005), Mah and Tamulaitis (2000).

[5] Please note, the data is collected on Romania prior to her entrance to EU, and on Ukraine prior to the turmoil generated by the dissolution of the Ukrainian parliament in 2007.

Several indicators will be considered herein, such as level of democratic freedom, level of global economic progress, countries' financial risks, and index of global competitiveness.

4.2.1 Level of democratic progress

According to the Freedom House, an independent non-governmental organization that supports the expansion of freedom in the world, freedom is possible only in democratic political systems in which the governments are accountable to their own people; the rule of law prevails; and freedoms of expression, association, belief and respect for the rights of minorities and women are guaranteed (www.freedomhouse.hu).[6]

Table 2 below provides a comparative snapshot of the three countries for 2006 (for the evolution of the ratings by countries and for the rating methodology, please refer to www.freedomhouse.hu).

Table 2. Level of democratic progress, 2006

	Romania	Ukraine	**Moldova**
Electoral process	2.75	3.25	**3.75**
Civil society	2.25	2.75	**4.00**
Independent media	4.00	3.75	**5.00**
National democratic governance	3.50	4.5	**5.75**
Local democratic governance	3.00	5.25	**5.75**
Judicial framework and independence	4.00	4.25	**4.50**
Corruption	4.25	5.75	**6.00**
Democracy score	***3.39***	***3.96***	***4.96***

Source: www.freedomhouse.hu

As the data indicates, Moldova is ranked 3rd on all the factors as compared to Romania and Ukraine. What drives mostly the score down for Moldova is (i) the lack of democratic governance both at the national and local levels, (ii) non-existence of genuinely independent mass-media, and (iii) the corruption.

For example, the Freedom House defines the corruption index as the public perceptions of corruption, the business interests of top policy makers, laws on financial disclosure and conflict of interest, and the efficacy of anticorruption initiatives. It concludes its report on Moldova by stating that: "*Moldova's business environment is subject to excessive regulations and a continuously changing legislative framework that makes it prone to corruption*".

To the above, the National Anticorruption Strategy recognizes that corruption gravely undermines Moldova's statehood by affecting all areas of public and private life.

[6] It ranks the countries from 1 to 7, with 1 representing the highest level of democratic progress (consolidated democracy) and 7 the lowest (consolidated authoritarian regime).

4.2.2 Global economic freedom

For over a decade, the Wall Street Journal together with the Heritage Foundation has analyzed the progress economic freedom around the world with the Index of Economic Freedom. They define the economic freedom as that part of freedom that is concerned with the material autonomy of the individual in relation to the state and other organized groups; an individual is economically free who can fully control his or her labour and property (www.heritage.org).[7]

Tables 3 and 4 below present the comparative analysis of the three countries and the evolution of the indexes for Moldova for the last three years respectively.[8] As the data suggests, having the overall score of 59.5, Moldova is being characterised as the country that is mostly un-free. As compared to Romania, apart from corruption, Moldova scores quite low on the investment freedom.

Table 3. Economic freedom in the region

Overall Rank	Country	Year	Overall Score	Investment Freedom	Financial Freedom	Property Rights	Freedom from Corruption
67	Romania	2007	61.3	50	60	30	30
81	**Moldova**	2007	**59.5**	**30**	**50**	**50**	**29**
125	Ukraine	2007	53.3	30	50	30	26

Source: www.heritage.org

Table 4. Economic freedom in Moldova

Overall Rank	Year	Overall Score	Investment Freedom	Financial Freedom	Property Rights	Freedom from Corruption
81	**2007**	59.5	30	50	50	29
81	**2006**	59.6	30	50	50	23
81	**2005**	55.1	30	50	50	24

Source: www.heritage.org

When looking at the barriers that drive this index down, one may quickly relate to the FDI barriers identified by the Foreign Investor Association in its 2006 White Book (www.fia.md). It is also interestingly to note (see Table 4), that for the last three years, little has been done to significantly improve the situations in the respective areas.

[7] The Index of Economic Freedom measures and ranks 161 countries across 10 specific freedoms, like business, trade, fiscal, monetary, investment, financial, property rights, labour freedoms, freedoms from Government and corruption. Each one of the 10 freedoms is graded using a scale from 0 to 100, where 100 represents the maximum freedom. A score of 100 signifies an economic environment or set of policies that is most conducive to economic freedom.

[8] Please be advised, that across all freedoms, the three countries have comparable results. Apart from those presented in the tables, the countries' freedom scores are in the range of 70 to 90, which denotes a significant level of improvement in the respective areas. For details, please see www.heritage.org.

4.2.3 Countries' financial risks

The financial risk of country determines the general credibility of a country to provide for certain investment environment. It also grades the factors such as relations with her neighbours, with IMF and World Bank, Government finance and debt, and the ability of a country to remain stable in the conditions of political changes.

The indexes of financial risks calculated by Standards and Poor, Moody's, and FITCH-IBCA are mostly referenced (see for example, https://entry.credit-suisse.ch). Table 5 below provides a comparative analysis of the financial risk among the three countries.

Table 5. Financial risks of the countries, 2007

	Romania	Ukraine	**Moldova**
Standard & Poor's	BBB- (positive)	BB- (negative)	n/a
Moody's	Baa3 (stable)	B1 (stable)	**Caa1 (stable)**
FITCH-IBCA	BBB (stable)	BB- (positive)	**B- (stable)**
Coface Group	A4	C	**D**

Source: https://entry.credit-suisse.ch

With regard to the countries' financial risks, Moldova comes third, being rated lower than her neighbours. For example, according to Moody's Investors Service, the credit strengths of Moldova are prudent fiscal and monetary policy and successful land reform. According to FITCH-IBCA, Moldova's strengths are i) a strong GDP growth (in 2006), ii) very high workers' remittances, and iii) reasonably well educated labour force.

However, the latter strengths provided by FITCH-IBCA could be challenged. Over the last six years, the amount of remittances grew almost tenfold, but the economy with GDP made of 40% from remittances is quite vulnerable to external shocks. The other challenge is the *availability* of the well educated labour force that currently is scarce in the market.

Some of the weaknesses mentioned by the above agencies are i) macroeconomic imbalances and low income per capita; ii) massive structural weaknesses across the economy; iii) no immediate access to credit and tight restrictions on policy; iv) inconsistent approach to structural reforms; v) vulnerability to external shocks.

Table xxx above also presents the ratings of the three countries provided by Coface Group that reflect the average level of short-term non-payment risk associated with companies in a particular country (www.coface-usa.com). That is, the ratings reflect the extent to which a country's economic, financial, and political outlook influences financial commitments of local companies.

Based on Coface's methodology and data, Moldova is graded with the lowest possible score, D that is characterized as "*the high risk profile of a country's economic and political environment will further worsen a generally very bad payment record*" (www.coface-usa.com).

One of the key reasons Moldova must improve its credit rating is because the low rating affects the level of the interests rates; higher the risk, higher the interest rates.

4.2.4 Global competitiveness

According to the World Economic Forum (www.weforum.org), the national competitiveness is a set of factors, policies, and institutions that determine the level of productivity of a country. Raising productivity — meaning making better use of available factors and resources — is the driving force behind the rates of return on investment which, in turn, determine the aggregate growth rates of an economy.

The Global Competitiveness Index, developed by the World Economic Forum is based on three factors: i) basic requirements, ii) efficiency enhancers, and iii) innovation (see Table 6). Rank number 1 denotes the most competitive nation out of 125 economies.

Table 6. Global competitiveness index, 2006-2007

		Romania	Ukraine	**Moldova**
Basic requirements		83	86	**88**
Efficiency enhancers		55	69	**85**
Innovation		73	78	**98**
Overall rank	***2006***	***68↓***	***78↓***	***86↑***
	2005	***67***	***68***	***89***

Source: World Economic Forum (2007)

To account for the evolution of the policies so that the countries move up the competitiveness ladder, the World Economic Forum developed stages of economic development (see Table 7).

Table 7. Stages of economic development

Stage 1 *Factor driven*	**1 → 2**	**Stage 2** *Efficiency driven*	**2 → 3**	**Stage 3** *Innovation driven*
Moldova		Romania		
Ukraine				

Source: World Economic Forum (2007)

Moldova and Ukraine are positioned at the stage 1 that is a factor driven stage in which countries compete on stable macroeconomic framework, well-functioning public and private institutions, appropriate infrastructure, and healthy, literate workforce (www.weforum.org).

Romania is positioned at the stage 2 of development in which competitiveness is driven by higher education and training, efficient markets, and the ability to harness the benefits of existing technologies.

One may argue that being behind Romania and Ukraine by 18 and 9 points respectively it is not bad. To appreciate these differences, one may look into the sub-factors of each factor of the Global Competitiveness Index.

Basic requirements factor

This factor consists of four pillars, namely the public institutions, infrastructure, macroeconomy, and health and public education (see Table 8 below). Moldova is doing well on the macroeconomy, however, is quite behind Romania on health and primary education, and behind Ukraine on the infrastructure. Overall all the countries are in a very close proximity.

Table 8. Basic requirements factor

	Romania	Ukraine	**Moldova**
Institutions	87	104	**101**
Infrastructure	77	69	**85**
Macroeconomy	97	74	**67**
Health and primary education	69	94	**92**
Overall rank	***83***	***86***	***88***

Source: World Economic Forum (2007)

Efficiency enhancers factor

As compared to basic requirements factor, Moldova is lagging significantly behind Romania by 30 points and Ukraine by 16 points (see Table 9 below). When compared across the sub-factors, one may notice that the status of the higher education and training is ranked much lower than in Romania and Ukraine. The situation is worse in the field of technological readiness[9]; benchmarked against Romania, Moldova is worse of by 47 points!

Table 9. Efficiency enhancers factor

	Romania	Ukraine	**Moldova**
Higher education and training	50	48	**73**
Market efficiency	76	80	**92**
Technological readiness	49	90	**96**
Overall rank	***55***	***69***	***85***

Source: World Economic Forum (2007)

[9] Technological sub-factor includes inter alia i) the firm-level technology absorption; ii) laws regulating ICT; and iii) FDI and technology transfer. For more details on this and other sub-factors, please visit www.weforum.org.

Innovation factor

The innovation factor consists of two pillars: business sophistication, and innovation. Benchmarked against both countries, Moldova again is ranked lower by more than 20 points (see Table 10 below). On innovation, Moldova is behind Romania by 32 points.[10]

Table 10. Innovation factor

	Romania	Ukraine	**Moldova**
Business sophistication	73	76	**93**
Innovation	68	73	**100**
Overall rank	***73***	***78***	***98***

Source: World Economic Forum (2007)

Competing in a technology driven global economy, this index is of a paramount importance since it contributes to the knowledge transfer and its absorption.

4.2.5 Networked readiness

The World Economic Forum developed the networked index – an index that measures the level of Information and Communication Technology (ICT) development of nations and that rests on three main sub-indexes, capturing (see Table 11 below):

- the presence of an ICT-conducive environment, regulatory aspects, soft and hard infrastructure,
- ICT propensity of individuals, business sector, government, and
- actual use of ICT by above stakeholders.

Table 11. Networked readiness, 2006

2006-2007	Romania	Ukraine	**Moldova**
Overall rank	55	75	**92**

Source: World Economic Forum (2007)

As the data suggests, Moldova is loosing ground to Romania and Ukraine; especially Romania by lagging behind by 37 points. A closer look at these sub-indexes is required in order to get an in-depth understanding of the current strengths and weakness of Moldova's ICT propensity.

4.3 Microeconomic competitiveness

According to the FDI confidence index (www.atkearney.com), investors see diminished macro risks, but growing micro risks. That is, micro risks are

[10] The innovation sub-factor includes inter alia i) quality of scientific research institutions; ii) company spending on R&D; iii) university/industry research collaboration; iv) government procurement of advanced technology products; v) availability of scientists and engineers; vi) intellectual property protection; and vii) capacity for innovation.

becoming more threatening. Corporate governance, IT disruption, product quality, safety problems and employee fraud have all gained importance according to the FDI confidence index. Next two subsections will provide a comparative analysis of Romania, Ukraine, and Moldova across several micro indicators.

4.3.1 Business competitiveness index

According to the World Economic Forum, making progress in macroeconomic, political, legal, social and technological areas is necessary, but not sufficient. They developed a Business Competitiveness Index that ranks the countries by their microeconomic competitiveness, identifies competitive strengths and weaknesses in terms of countries' business environment conditions and company operations and strategies, and provides an assessment of the sustainability of countries' current levels of prosperity (see Table 12 below).

Table 12. Business competitiveness index, 2006

	Romania	Ukraine	**Moldova**
Quality of the national business environment ranking	73	80	**91**
Company operations and strategy ranking	73	82	**91**
BCI ranking	***74***	***81***	***90***

Source: World Economic Forum (2007)

Moldova once more scores low on the productivity of companies as compared to Romania and Ukraine. Interestingly to note that high-income nations, like Hong Kong (up 7 ranks) and Norway (up 5 ranks), improved their rankings by registering strong improvements in i) management education, the efficacy of government boards, and local availability of process machinery; and ii) benefiting from increasing intensity of local competition, the availability of venture capital, and efficiency of legal framework, respectively.

A closer look at this index is required in order to better understand what makes Moldovan companies less competitive and ultimately how to sustain the prosperity over time.

4.3.2 Ease of doing business

The ease of doing business index ranks economies from 1 to 175, with first place being the best. A high ranking on the ease of doing business index means the regulatory environment is conducive to the operation of business (www.doingbusiness.org). Table 13 below presents the comparative data for Romania, Ukraine and Moldova on all the indicators that make up the ranking.

Here Moldova is doing a little bit better than Ukraine in the areas of starting a business, registering property, protecting investors, and closing a business. However, if compared to Romania, Moldova is positioned quite far, being down by more than 50 points. Two indicators are detailed below which have the highest weight in making the difference.

Table 13. Ease of doing business, 2007

	Romania	Ukraine	**Moldova**
Starting a business	7	101	**84**
Dealing with licenses	116	107	**119**
Employing workers	101	107	**128**
Registering property	114	133	**47**
Getting credit	48	65	**101**
Protecting investors	33	142	**99**
Paying taxes	131	174	**119**
Trading across borders	35	106	**105**
Enforcing contracts	45	26	**55**
Closing a business	108	139	**78**
Ease of doing business	***49***	***128***	***103***

Source: www.doingbusiness.org

Starting a business

It is quite remarkable to see Romania being ranked 7 on starting a business. Table 14 below details the sub-indicators for the 'starting a business indicator'. As the data suggests, in Romania it takes 5 procedures, 11 days, and 4.4% of annual income per capita (or $169) in fees to open a business. No minimum capital is required to start a business.

Whereas in Moldova, it takes 10 procedures, 30 days, and 13.3% of annual income per capita (or $117) in fees to open a business. The minimum capital required amounts to 18.8% of income per capita (or $165).

Table 14. Starting a business

	Romania	**Moldova**
Procedures (number)	5	**10**
Time (days)	11	**30**
Cost (% of income per capita)	4.4%	**13.3%**
Minimum capital (% of income per capita)	0.0	**18.8%**
Starting a business rank	***7***	***84***

Source: www.doingbusiness.org

Trading across borders

In the light of current restructuring efforts of the border guards, customs and other border related services, Moldova trails behind Romania by 70 points (see Table 15 for details). As the data points out, documents and times to export and import are the problems of immediate concern; if solved, the ranking, and ultimately the attractiveness could be improved significantly.

Table 15. Trading across borders

	Romania	**Moldova**
Documents to export (number)	4	**7**
Time to export (days)	14	**33**
Cost to export ($/container)	1,300	**1,185**
Documents to import (number)	4	**7**
Time to import (days)	14	**35**
Cost to import ($/container)	1,200	**1,285**
Trading across borders rank	***35***	***105***

Source: www.doingbusiness.org

It is important to acknowledge the fact that the ease of doing business index is limited in scope. It does not account for a country's proximity to large markets, the quality of its infrastructure services (other than services related to trading across borders), the security of property from theft and looting, macroeconomic conditions or the strength of underlying institutions (www.doingbusiness.org).

4.4 Investment incentives mechanisms

Apart from analysing non-financial incentives, it is also critical to explore the financial investment incentives mechanisms in the region and to understand what makes up the difference in attracting FDI. Table 16 below summarises the generic approaches undertaken by all three countries to financial investment incentives.

Table 16. Investment incentives in the region

	Romania	Ukraine	**Moldova**
Exemption from VAT & import duties on imported capital	√	√	
Exemption from VAT & import duties on imported materials	√		√
Exemption from VAT on services related to exports		√	
Corporate tax holidays	√		√
Accelerated depreciation	√	√	
Re-investment allowance	√	√	√
Special deductions	√	√	√
Deductions of promotional costs	√		
Possibility to carry forward losses	√	√	√

Source: the Authors

From a quick look at the table, one may observe, the financial incentives instruments are more or less the same throughout the region. Two differences could be singled out though which are quite pivotal in fostering FDI inflow and entrepreneurship. These are accelerated depreciation and deductions of promotional costs. Detailed account of each country's investment incentives instruments will be discussed below.

4.4.1 Investment incentives in Romania

Before joining EU

Prior to joining EU, Romania undertook significant efforts in fostering FDI inflow, and SME (Small and Medium Enterprise) growth and development.[11] Specifically, investment incentives have been developed particularly to boost the acceleration of industrialisation in underprivileged zones, as well as the development of SMEs, oil and gas sectors and micro-enterprises (www.kpmg.ro).

The FDI policy provided financial incentives for large investments with significant impact on the economy, SMEs, micro-enterprises, economic zones, industrial parks, and free trade zones. For example, with regard to the investments with important impact on economy, the Romanian Fiscal Code provided (www.kpmg.ro):[12]

- an additional deduction of 20% of the value of the investment,
- the possibility to carry forward fiscal losses over the following 5 years and offset them against gains arising from similar operations,
- the possibility to use accelerated depreciation (except for investment in buildings).

As regards the development of SMEs, several measures to foster SME growth were offered by the legal framework, namely (www.kpmg.ro; for detailed review see also www.ceinet.org):

- provide entrepreneurs with non-reimbursable funds to enable them to reach necessary share capital at start-up,
- provide entrepreneurs with non-reimbursable financial aid to support investment in production and services,
- ensure the financial means necessary to co-finance and efficiently use the financial aid granted by EU,
- allocate 0.2% of GDP annually to finance programmes meant to support start-ups and development of SMEs,
- provide non-refundable financial support for staff training,
- provide non-refundable financial support for promoting exports.

In 2002, the Romanian Parliament adopted a law that set forth the incorporation of the Romanian Agency for Foreign Investment (www.arisinvest.ro). The main tasks of the Agency are to apply the Government's policy for the promotion and attraction of FDI.

According to the Business Media Group (www.bmg.ro), legal regime of foreign investments in Romania underwent a series of changes as the time went by, nonetheless it has remained unrestricted, setting forth commonly recognized principles such as: free access to the market and to all fields of business; equal treatment of foreign and domestic investors, residents and non-residents; the right of foreign investors to repatriate the income earned in Romania, net of all

[11] For a comprehensive review of the legal framework regulating FDI and the evolution of FDI in Romania prior to joining EU please visit www.doingbusiness.ro.

[12] Please refer to the following sources for detailed information on financial incentives: www.bmg.ro, www.avocatdiaconescu.ro, http://rbd.doingbusiness.ro, www.pwc.com/ro, www.ceinet.org, www.investmentcompact.org (Enterprise Policy Performance Assessment: Romania).

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taxes and levies; protection of investments by specific warranties against nationalization, expropriation and other equivalent measures.

After joining EU

In order to harmonise the FDI policies to the European context, the Romanian government has initiated a draft law on investments that has not been yet passed by the Parliament, but it has been made available for public debates (the draft law could be accessed here www.guv.ro/obiective/dma/leg_inv_en131106.pdf).

This draft law provides for a general framework of facilities to be granted to investors, benefiting from a non-discriminatory treatment so that any investor will have the chance to enjoy the facilities provided under this draft (www.bmg.ro). Specifically, this draft law is based on the following principles: free access, mutual acknowledgement, transparency and monitoring, equal treatment, efficiency in using funds, and confidentiality.

However, this draft law leaves rooms for interpretations. For example, KMPG (www.kpmg.ro) questions the effectiveness of the incentives set forth in the draft law, since they can create a risk of unfair competition if they are not granted in an orderly or transparent way.

Nonetheless, according to Ernst & Young (www.ey.com), Romania is perceived by investors as most attractive destination. It is viewed to have a good strategic position, EU membership, and favourable country-risk indicators. On the other hand, Romania has yet to achieve a clear and stable legislation, as well as predictable tax system, rather than promoting a large number of complex incentives (www.bmg.ro).

4.4.2 Investment incentives in Ukraine

Since the early days of the post-independence period, legal conditions affecting foreign investment in Ukraine have frequently changed. According to Deloitte Touche Tohmatsu (www.deloitte.com), at first, foreign investors were offered generous incentives, including exemption of joint ventures from corporate profit tax for the first five years of their activities. This major incentive, however, was scrapped in 1997 and never restored, even though many affected companies successfully contested the ban in courts.

Gradually, over the years, most special tax preferences granted to foreign investors were liquidated; some though still remain.[13] For example a corporate tax rate of 15% for non-residents, as opposed to 25% standard corporate profit tax used in other cases (www.deloitte.com).

The main piece of legislation that at present regulates the foreign investment in Ukraine is the Law on the Regime of Foreign Investments (this law could be accessed here www.kmu.gov.ua/control/publish/article?art_id=10256142). The main feature of this law is that it equated business conditions for national and foreign investors by introducing the so-called national regime. That is, foreigners have the same rights to invest in Ukraine as Ukrainian individuals and legal entities.

Provided foreign investors comply with certain rules and regulations, according to this law, the following incentives and guarantees apply to foreign investors:

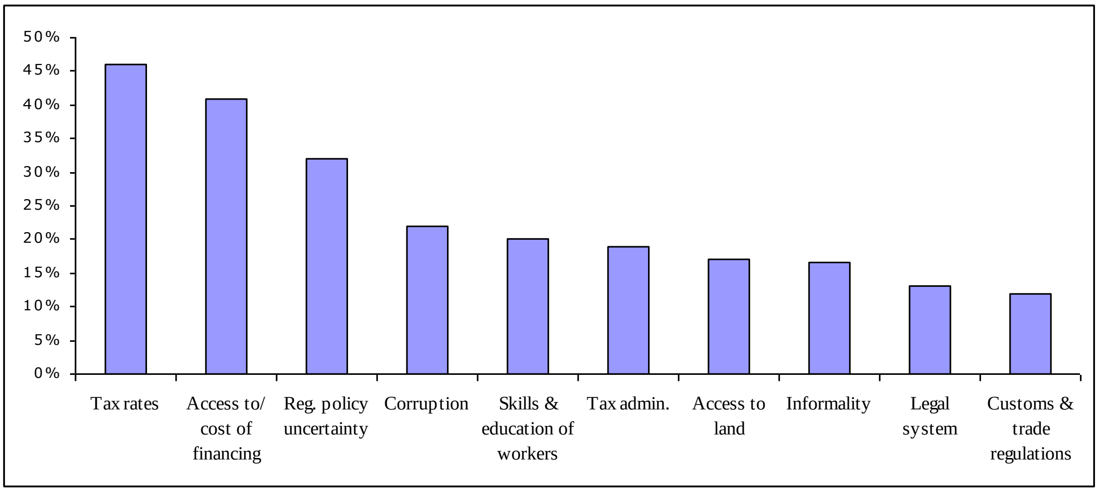
[13] For a broader view of the investment incentives in Ukraine and their evolution, please also see http://e-fpo.go.th, http://lviv.biz; www.brama.com, www.fdi.net.

- protection for ten years against adverse changes to the investment guarantees contained in the law,
- investments may not be expropriated, except in the case of national emergency and with proper compensation,
- compensation should be provided to cover losses incurred due to the negligence of state bodies,
- the right to repatriate the original investment in the event of termination of this investment.

To avoid double taxation, Ukraine concluded double-tax treaties with more than 50 countries (www.ey.com). According to Vienna Institute for International Economic Studies (www.wiiw.ac.at), in Ukraine, GDP growth accelerated markedly in 2006; macroeconomic imbalances were largely avoided and the 'gas price shock' reasonably well digested. Inflation apart, the country's short-term economic outlook is good.

Figure 4 below presents the top ten constraints to firm investment in Ukraine. As the data suggests, top five constraints are the high tax rates, difficult access to funding, uncertainty of Government's regulations, persistence of corruption, and diminishing level of skills and education of workers.

Figure 4. Top ten constraints to firm investment in Ukraine, 2005



Source: www.enterprisesurveys.org

4.4.3 Investment incentives in Moldova

Overall the financial investment incentives mechanisms in Moldova target three major areas: i) large investments with significant impact on the economy, ii) commercial banks, and micro and small businesses.[14]

Table 17 below provides a summary of the corporate income tax incentives provided under the amendments to the Fiscal code applicable with 2007. These exemptions are effective starting from the first day of the year in which the

[14] For detailed overview of current tax incentives in Moldova please refer to *Business Guide to Moldova* by PricewaterhouseCoopers (www.pwc.com), or *Doing Business in Moldova* by Ernst & Young (www.ey.com). For detailed review on barriers to FDI inflows and foreign companies' operations in Moldova please refer to the White Book by the Foreign Investor Association (www.fia.md).

agreement on corporate income tax exemption was sighed with the Tax Authority.

Micro and small enterprises[15] can be eligible for certain incentives; they may be exempt from corporate tax of a period of three years. ICT companies can receive an exemption from income tax and salary income tax for a five-year period. Companies are entitled to VAT refund on new machinery. Recently new legislation was passed that sets forth 0% corporate income tax on reinvested profits. To avoid double taxation, Moldova concluded double-tax treaties with 28 countries (www.pwc.com).

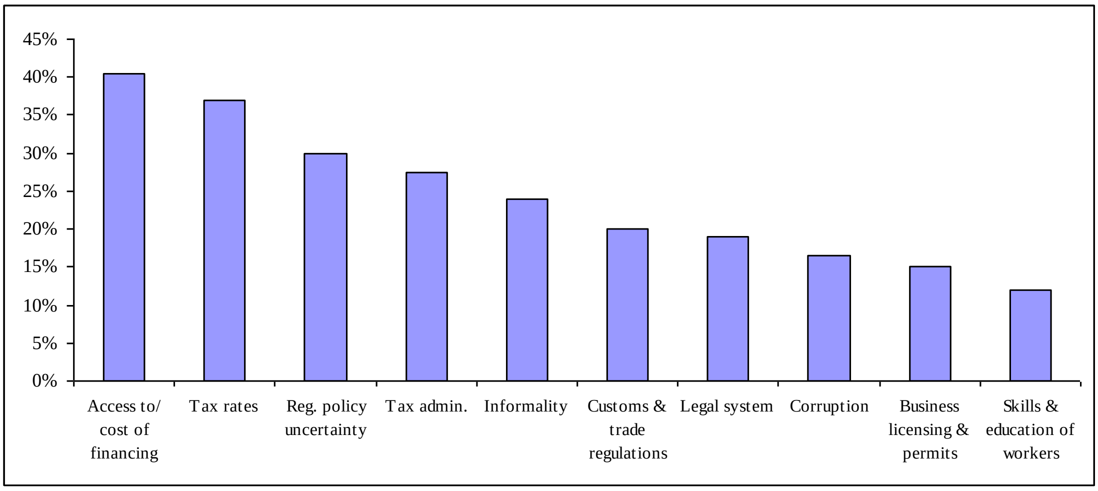
Table 17. Corporate income tax incentives in Moldova, 2007

Contribution to the statutory capital or amount of capital investments (expenses), USD	Period of enjoyment, years	Required minimum level of exempted CIT which must be invested in own production or in governmental programmes, %
2,000,000	3	80
5,000,000	3	50
10,000,000	3	25
20,000,000	4	10
50,000,000	4	-

Source: www.pwc.com

Figure 5 below presents the top ten constraints to firm investment in Moldova. As the data suggests, top five constraints are cost of funding, high tax rates, uncertainty of Government's regulations, high average time spent in meeting with tax and other officials, and the existence of informal economy.

Figure 5. Top ten constraints to firm investment in Moldova, 2005



Source: www.enterprisesurveys.org

[15] As defined in the fiscal legislation, a small enterprise has between 1 and 19 employees with annual net sales of up to MDL 3,000,000.

In August 2006, the Moldovan Investment and Export Promotion Agency restarted its activities; it was born again as Phoenix from the ashes. The Agency is in its infancy stage now and requires lots of support.

Recently (in April, 2007), the IMF resident Representative in Moldova, commenting on the announced capital, fiscal and tax initiatives, stated that fundamental steps to improve the business climate – including the elimination of corruption in the judicial system, market competition reform, and reducing government interference in the economy – are likely to be more important that just the proposed tax measures for promoting investment, economic growth, and poverty reduction in Moldova (www.imf.md).

4.5 Conclusion

The previous chapter reviewed the extant literature on the role of investment incentives in attracting FDIs. One of the major findings emerged from that review was that unless the fundamentals of the countries in the region are more or less equal, the financial investment incentives will have an insignificant impact on attracting FDIs.

In light of the above, this chapter aimed at comparing traditional operational risks, microeconomic competences, and investment incentives mechanisms in Romania, Ukraine, and Moldova.

The comparative review of the abovementioned indicators demonstrates that there exist significant differences between these countries in terms of political, economic, market and infrastructure factors. On most of the comparative indices Moldova comes 3rd, being positioned somewhere close to Ukraine, but quite behind Romania. Major differentiators are (not in the order of importance):

- corruption,
- investment and financial freedom,
- country financial risk,
- infrastructure,
- higher education and research,
- innovation & technology.

In terms of the costs of doing business in Moldova, these are still high. Several differentiators emerged as a result of the comparative analysis (not in the order of importance):

- VAT refund is a burdensome process
- Barriers to grow (e.g. Joint Stock Company Law, art. 39, www.fia.md)
- Regulatory environment is unstable
- Low quality of bureaucrats
- Risk of nationalisation/expropriation
- Difficult to enforce the contracts
- Scarce qualified human capital
- Poor education system
- High costs of starting a business
- Lots of inspections
- Corruption and bribery
- State interference with entrepreneurial activity

As regards the investment incentives mechanisms, the analysis revealed that investment incentives instruments in the region are comparable. If benchmarked against Romania, three critical incentives, which could be followed, stood out, namely i) accelerated depreciation, ii) deductions of promotional costs, and iii) various incentives to support SMEs and foster entrepreneurship.

Overall, the incentive mechanisms in Moldova, implicitly, are geared towards supporting Multinational Enterprises (MNEs) rather than SMEs, and attracting market-seeking FDIs, rather than for example attracting efficiency-seeking FDIs.

Given the above differences in fundamentals between the three countries, and the similarities in investment incentives mechanisms, one might expect the existing tax and other financial investment incentives in Moldova may not have a significant impact on FDI inflows and thus on the growth of the economy.

5 INTERVIEWS IN MOLDOVA

5.1 Introduction

The views and opinions of investors in Moldova, based on their first hand experience of working in the country, are important in relation to any future changes that might be proposed. Investors, their advisors, and other actors on the Moldovan foreign investor stage are a valuable source of information on incentives for investment and the wider investment climate in the country.

Interviews were arranged with individual investors, representatives of industry and sector associations, and with legal, accountancy and banking advisors. Representatives of the diplomatic community were also interviewed on the basis that for many foreign investors, their first contact with Moldova is through the trade attaché or commercial counsellor at their national embassy.[16]

A total of 15 interviews were conducted (see Table 18). Some of the interviews that had been arranged were cancelled by the interviewees due to unforeseen circumstances. The time constraints of the study did not allow more interviews to be undertaken, but nevertheless the data started to converge towards the end thus being sufficient to draw several conclusions.

Table 18. List of interviewees

Group	**Number of interviews**
Investors	5
Trade associations /Industry groupings	4
Legal advisors	2
Accountancy advisors	2
Diplomatic	1
Banking	1

Source: the Authors

An open question format for the interview was adopted. In each case, the background to the interview was explained, including a brief outline of the support to MIEPO project, the study of incentives for investment within the project and the approach that was being taken in carrying out the study. After this short introduction, the following generic questions were asked:

- To outline their background and experience in Moldova
- To provide their views on the overall investment climate in the country
- To express their views and thoughts on how the situation could be improved, particularly in relation to incentives for investment.

[16] The groupings of diplomats, trade associations, professional advisers and Chambers of Commerce, who represent investors or are in contact with them and are able to influence them, are often referred to as 'multipliers' and are important from an investment promotion (image building and investment generation) perspective; the multiplying effect of working through such groups can be very powerful.

5.2 Findings

Based on the notes taken during the interviews, a summary of each interview was made and the main points made by the interviewee noted. Key issues identified by interviewees are discussed below.[17]

An aggregation of the main points made in response to the question, 'how could the investment climate in Moldova be improved, particularly in relation to incentives', is given in the Table 19 below.

Table 19. How investment climate could be improved

Improvement	Number of times mentioned
Improve the legal and regulatory environment	11
Improve the tax regime and its administration[18]	6
Establish proper promotion of investment opportunities	5
Address corruption	5
Establish political stability	4
Improve education and skills	4
Support SME development	3
Eliminate the risk of property/business expropriation	3
Improve the labour market	2
Establish economic stability	2
Upgrade professionalism in Government administration	2
Improve infrastructure	1
Improve utilities	1
Improve workings of National Securities Commission	1

Source: the Authors

The problem mostly cited by investors was the over-extensive regulation that is oftentimes unpredictable. The improvement of the legal and regulatory environment for investment is a wide-ranging umbrella covering many specifically mentioned topics. These included:

- Political interference, including the risk of expropriation
- Unfair competition with no legislation or political will to resolve it
- Large number of inspections imposed on companies by the legislation
- Uncertainty in the implementation of the legislation
- Lack of transparency and accountability of the Government
- Inefficient reporting system
- Low degree of enforceability of the contracts

[17] Many of the problems identified by interviewees are detailed in the White Book produced by the Foreign Investors Association (www.fia.md). The White Book provides a detailed analysis of the problems faced by foreign investors in operating in Moldova with recommendations for improvements in the legislation. FIA represents a number of significant investors in Moldova.

[18] Comments on improving the tax regime and its administration were usually made in the context of VAT repayments and on a number of occasions in respect to VAT on machinery imports.

Earlier analysis of Moldova investment climate as compared to Romania and Ukraine showed that the competitiveness of Moldova is heavily dragged down by the above issues mentioned by interviewees (see chapter 4 for details).

To a certain degree, related to the above is also a finding regarding the quality of the bureaucrats. Specifically, it is the lack of understanding of investors' language, especially their views of and believes in the market economy, and of investors' culture.

The other major issue that emerged from interviews is the quality and availability of human capital. This was explained first of all by the poor and continuously deteriorating higher education system. Secondly, it is due to the large gap that currently exists between the disciplines needed on the market and the once produced by the universities. And thirdly, there is a high employee turnover, primarily driven by immigration.

The above findings to a certain degree corroborate earlier discussion in that i) for investors worldwide the local skill quality and availability are growing in importance (Nunnenkamp, 2002), and ii) Moldova scores quite law on the quality of higher education and training as compared to Romania and Ukraine (World Economic Forum 2007; see Table 9 for details).

Several investors are already trying to address the above issues by investing in vocational training and higher education. Examples include funding i) subject related Olympiads, ii) chairs at the universities, iii) knowledge transfer offices at the universities in the regions outside the capital, iv) continuous in-house trainings. The above investment activities of the foreign companies are good examples of spillover effects Moldova needs and the Government shall encourage, including via various incentives provision.

The strategic position of Moldova between the East and West, as well as the neighbour of EU was highlighted by several respondents. However, in order to capitalise on this opportunity, Moldova has to invest heavily in the infrastructure so that it corresponds to the European standards. And more importantly, the infrastructure projects must be developed taking into account the regional context.

The other major concern that was raised related to fostering entrepreneurship and SMEs' growth. Several issues emerged. One is the lack of incentives instruments for local SMEs. Two, SMEs do not have access to capital to ensure long term financing.19 Three, rather than encouraging green field investments, the Government shall focus on attracting foreign SMEs. And four, Moldova needs serious investors to help raise the standards and sophistication of local firms.

It was significant that not one interviewee suggested that financial incentives for investment should be increased in order to enable Moldova to attract and secure more FDI. This would appear to confirm the view that emerged from the examination of the research and studies carried out in other countries that few investors look at tax incentives in relation to investment decisions (see chapter 3 for details). Overall, it was felt by interviewees that it would help if the Government was a bit friendlier towards investors.

[19] Related to this is a clause from the Joint Stock Company Law that limits the growth of the company by restricting the net asset value of a Joint Stock Company. Please see FIA' White Book: 2006 (www.fia.md) for detailed discussion on this issue.

5.3 Conclusion

In this chapter the results of the in-depth interviews were provided. The interviews were conducted with foreign investors in Moldova and their representatives with the aim to hear their views and opinions in relation to their experience and any future changes that might be proposed in order to enhance the investment climate in Moldova. A total of 15 interviews were conducted.

Overall the emerged findings provide support to the extant research on the role of the investment incentives in attracting FDI inflows. Specifically, the data suggests that investors are considering non-financial incentives as important determinates in making investment decisions. The interviews suggest that companies are more influenced by the general investment climate and other factors such as political and economic stability than by financial incentives.

The findings also provide support to the analysis of Moldova's competitiveness provided by various international organisations, like OECD, WB, and World Economic Forum. Distinctively, the data points to issues related to corruption, political interference, regulatory constraints, poor and continuously deteriorating infrastructure, low quality of and scarce human capital.

Three generic policy areas were identified by the respondents that require immediate to medium term intervention from the Government. These are: i) ease of doing business, ii) higher education, iii) infrastructure, and iv) fostering entrepreneurship.

6 CONCLUSIONS AND RECOMMENDATIONS

6.1 Introduction

This study aimed at understanding the role of investment incentives in attracting FDI into Moldova by i) reviewing the extant research, ii) comparing the investment incentives climates in the region, and iii) exploring in depth the investment climate in Moldova. After considering the information obtained from the three separate strands of the study, a number of conclusions can be drawn.

6.2 Investment climate

The findings from the literature review, from the comparative analysis of the competitiveness of Romania, Ukraine and Moldova, as well as from in-depth interviews with the foreign investor community in Moldova underscore the fact that the single most important *investment incentive* for investors is the overall investment climate that includes inter alia:

- macroeconomic
- political and social stability
- economic liberalisation
- competition conditions
- amenable investment environment
- people
- improved infrastructure
- strategic location
- strong competition
- linkage creation
- technical networks.

As to the financial incentives, they may play a role in a situation where the above non-financial incentives are equal. In general, tax incentives usually neither make up for serious deficiencies in the investment environment nor generate the desired externalities. The findings also demonstrate that financial incentives will generally neither affect significantly the amount of FDI that takes place nor usually determine the location to which investment is drawn.

To ensure higher level of FDI inflows and better and more efficient use of respective investments, the following three generic objectives are suggested to guide future policy decision making.

One, a paradigm shift is required in the country's FDI policy by explicitly focusing on *attracting foreign SMEs*. Two, investment incentives instruments must be linked to performance requirements that would *encourage spillover effects* thus ensuring social return on investment. And three, there should be developed incentives for local SMEs to allow them to *increase* their *absorption capacity*.

Several strategies could be developed to achieve the above objectives, like:

- to promote efficiency– and/or strategic assets-seeking FDIs rather than market-seeking FDIs
- to design and implement a management by objective promotion programme
- to conduct on a regular basis a research to explore the balance between social and private returns on investments

- to establish a Knowledge Transfer Office (KTO) to enhance the links between universities and the business sector.

A continuation and acceleration of the efforts to improve the investment climate, based on the inputs of the FIA and others, should be a major focus for Moldova.

6.3 SME sector

The main engines of economic growth are SMEs. Against the background of the small domestic market in Moldova it would seem logical to focus efforts on the development of SMEs in the country, including a focus on attracting investment from foreign SMEs.

The financial incentives currently available in Moldova do no have a particular orientation towards SMEs. But facilitation support, infrastructure, premises and a better investment climate, especially in relation to inspections and bureaucracy, could be more important as an incentive than financial incentives for this group of potential investors.

The experiences of Romania in their efforts to develop the SME grouping could be particularly valuable to Moldova.

6.4 Skills and education

The evidence from the research suggests that the *quality and availability of local skills* is growing in importance as means to attract investment and help local companies to absorb new technologies. As the knowledge based economies continue to grow in importance, so the need for increased and better human capital will grow in parallel. If Moldova is seeking investment from these economies, then investment in the education system to provide the skills required is needed.

The evidence that skills and the availability of human capital are an incentive that will attract investment is strong. This is particularly applicable to the ICT sector, where the availability of skills is the major driver and determinant of investment location. The need for Moldova to respond with a review and upgrading of the education regime in the country, particularly in the fields of higher education and life-long learning, is clear, particularly if ICT is to be a target for investment.

The ICT sector is by its nature broad and impacts on all other economic, educational, entertainment and social activities. It is not only an important economic activity in its own right but also a catalyst for enabling business processes and industrial competitiveness in all other sectors. The multiplying or spin off effect of the development of the ICT sector will positively impact on all other sectors in Moldova. The case for Moldova moving to provide the human capital needed for ICT development is quite compelling.

6.5 Delivery mechanism for investment

Although the improvement of the investment climate is important for Moldova in its efforts to secure increased FDI, it is on its own not sufficient. The attraction and securing of investment is basically a selling activity, spearheaded by a marketing organisation, usually an Investment Promotion Agency (IPA), which essentially acts as the delivery mechanism for investment. The effective operation of this delivery mechanism is critical for success.

A word of caution should be expressed though on the role of an Investment Promotion Agency in attracting FDI inflows. The research suggests that countries with a relatively poor investment climate or low income per capita should focus on improving these factors rather than spending on promotion. Hence, the cost-benefit analysis of a promotional campaign is required.

The attraction of foreign investment is a highly competitive business. Practically every country in the world is seeking such investment and to secure it requires a pro-active, targeted, professional marketing organisation. One cannot simply wait for the investment to arrive. It must be brought in and this requires the IPA to deliver results.

The efforts of the Support to MIEPO Project to develop MIEPO into a professional and sustainable institution capable of achieving results in the form of actual investments into Moldova are judged to be critical for the future economic development of the country.[20]

[20] The acknowledged success of Ireland in attracting FDI was certainly influenced by the prevailing investment climate, including its favourable corporate tax rates, but was also in no small part due to the ruthless efficiency of the IDA (the Irish IPA) as the means for identifying and securing that investment. The IDA was a focused, professional, determined and performance-driven organisation, staffed with high calibre executives, who were specially trained, highly rewarded, well managed and required to deliver results.

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